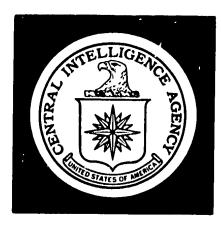
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CIA-RDP85T00875R00160003
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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Economic Consequences Of Israeli Military Expenditures

ER IM 70-33 March 1970

Copy No. 33

Declassified in Part - Sanitized Copy Approved for Release 2011/10/31: CIA-RDP85T00875R001600030033-2

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CENTRAL INTELLIGENCE AGENCY Directorate of Intelligence March 1970

INTELLIGENCE MEMORANDUM

Economic Consequences
Of Israeli Military Expenditures

Introduction

Since the June 1967 war, Israel has greatly increased its foreign exchange expenditures for military purposes while sustaining very rapid growth of the economy and of civilian imports. The war also induced a large increase in foreign remittances. In 1967 these more than covered the added foreign exchange spending, and foreign exchange reserves rose greatly. In 1968 and 1969, however, remittances declined, and Israel had to draw down its foreign exchange reserves to about \$400 million. Israel is now projecting a continued high level of military imports during 1970-74. This memorandum examines the economic impact of high foreign military expenditures during recent years and considers Israel's capability to finance its projected military expenditures.

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Strategic Research and the Office of Current Intelligence.



The Pattern of Growth, 1950-65

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- 1. Israel has a highly developed and dynamic economy. The economy is industrialized. diversified, technically advanced, and institutionally sophisticated. It continues to rely heavily on foreign resources to finance investment, however, which, together with immigration, helped to generate an 11% average annual growth of real gross national product (GNP) between 1950 and 1965.
- 2. Israel has grown rapidly despite a severe paucity of natural resources, in large measure through the efficient use of immigrant labor, many of whom were already skilled. Net immigration, which amounted to 165,000 in 1951 and then averaged 33,900 annually during 1952-65, accounted for 45% of the increase in total population of about 4.8% annually and probably for about one-half of the 5% annual increase in employment.
- Efficient utilization of immigrant labor has required substantial capital investment. Capital stock in real terms increased about 13% a year during 1951-65, and the share of net investment in GNP varied from 18% to 29%. The average annual net inflow of foreign resources (as measured by the deficits on transactions in goods and services) was equivalent to about 77% of net investment during 1951-65, and this ratio, although fluctuating from year to year, has not changed significantly since the early 1950s. About 70% of the net capital inflow consisted of private gifts, primarily from world Jewry and official government compensation payments from Germany.* Other sources of foreign funds have included official foreign aid from the United States, sales of Israeli Development Bonds, and a small volume of direct private investment in Israel.

The 1966-67 Recession

4. Israel's economy suffered a major reverse in 1966 when real GNP growth plummeted to 1%.

^{*} As these inflows are not repaid, they are designated in balance-of-payments statistics as "unilateral transfers."

Per capita GNP actually declined by 2%, and private investment, with the exception of some export industries, fell sharply. Although recovery began in the second half of 1967, GNP rose by only 2% for the entire year. This recession can be attributed largely to deflationary government actions and to a sharp decline in construction caused primarily by an unexpected fall in immigration.* Government measures were designed to ease balanceof-payments pressure through a combination of reducing economic growth slightly to 7%-8% annually -from 10%-11% -- and of accelerating export growth. The impact of the deflationary policy on the economy was far greater than anticipated, and the trade deficit declined markedly. Because of a drop in gifts and other remittances and capital inflows, however, the balance of payments did not improve (see Table 1).

5. Faced with large-scale unemployment, discontent over economic conditions in general, and the proximity of national elections, the government reversed its policy in the first half of 1967 and attempted to reflate the economy. But, although money became more plentiful and interest rates were lowered, consumer spending remained sluggish, and cautious businessmen were not investing. Unemployment leveled off by June 1967 but remained high at about 80,000, or 9% of the labor force.

The Post War Period

6. Except for a period of three to four weeks of extensive mobilization, when unemployment was reduced sharply, exports dwindled, and imports declined, the Arab-Israeli war had little direct impact on the Israeli economy. With the return of most of the reserves to civilian life, the economy returned to normal. A tax increase and a domestic bond issue, designed in part to finance a prolonged war, proved unnecessary, and the increase in taxes was rescinded shortly after the war.

- 4 -

^{*} Net immigration, which averaged about 44,000 annually during 1961-65, declined to about 23,000 in 1965 and then dropped to about 7,000 in 1966 and about 5,000 in 1967.

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a. Because of rounding, components may not add to the totals shown.b. Based on nine month data.

c. Reflects changes in net holdings of gold and foreign exchange within Israeli banking system. A minus sign denotes an increase.

d. Assumes that non-monetary short-term capital movements and errors and omissions net out to zero.

- 7. The June 1967 war acted as a catalyst, however, in ending the two-year-old economic recession. The war induced a very large increase in foreign gifts, from \$292 million in 1966 to \$521 million in 1967. In addition, the net inflow of repayable capital increased from \$184 million in 1966 to \$303 million in 1967, primarily because of increased overseas sales of Israeli Development Bonds. These receipts from gifts and loans greatly improved the balance of payments and enabled the government to pursue vigorously expansionary policies. Two supplementary budgets totaling \$274 million* were adopted. The extra funds were earmarked for defense purchases, industry, tourism, and retraining workers. The reflation program was effective; during the second half of 1967, compared with a year earlier, unemployment declined by 18% and GNP increased by nearly 11%. During 1968, however, imports increased about 41%, and the current account** deficit reached \$532 million -- about 20% greater than in 1966.
- Israel used the British devaluation of 18 November 1967 as an opportunity to devalue its own currency. The new Israeli exchange rate, which maintained the pre-November ratio between the British and Israeli pound, potentially made Israeli exports more attractive in most other countries. The government also expected that this action would make foreign as well as domestic investment in export industries more appealing. The main impact of the devaluation was deliberately limited to the export side; the government offset most of the effect on import prices by reducing tariffs and has since pursued a liberal import policy to help absorb the growth in aggregate demand as well as to support the growth of production.
- 9. The strong upward trend in economic activity continued into 1968. The decisive victory over the Arabs, the unexpected inflow of foreign capital, and a substantial increase in government expenditures all combined to restore

^{*} At the pre-November 1967 exchange rate of \$1 to three Israeli pounds.

^{**} The current account in the Israeli balance of payments excludes unilateral transfers because of their almost unique role in Israeli finance.

Israeli investor confidence. As a result, gross capital formation in real terms increased nearly 44% in 1968, to near the 1965 (pre-recession) level. There were also substantial increases in private and public consumption. Because the recession had caused substantial unemployment of labor and plant capacity, the economy was able to respond to rising demand with extremely rapid growth of production. In real terms, GNP in 1968 increased by more than 13% and per capita GNP by nearly 10%. At the same time, employment rose almost 10% while the average unemployment rate fell from 9% of the civilian labor force in 1967 to about 6% in 1968. Despite a 14% increase in the money supply (26% if quasi money is included), the consumer price index rose only 2% because of large increases in production and imports.

- 10. The pace of economic expansion remained high through 1969 as GNP grew by 12% and investment by 26%, even though the government shifted to mildly restrictive monetary policies. Most of the remaining slack in the economy was taken up as unemployment fell to 4% of the labor force. Nevertheless, the price level increased by less than 4%, primarily because union-government wage stability agreements continued to be enforced.*
- 11. Exceptionally rapid economic growth since mid-1967 has increased imports substantially and pushed up the trade deficit. The 1967 devaluation apparently helped boost Israeli exports of goods and services, which increased by 25% in 1968 and an estimated 10% in 1969, but imports of goods and services (including military purchases -- see paragraphs 12 and 13) increased even more rapidly, by 28% in 1968 and by an estimated 16% in 1969. Civilian imports alone grew by more than one-half between 1967 and 1969 and the current account deficit, excluding military purchases, reached a new high.

^{*} Wage rates generally are controlled by agreements between the government and the Histadrut (the omnipresent labor union). The agreement in effect during 1967-69 provided that labor will not push for higher wages provided the government does not raise taxes.

- Accompanying the rise in civilian imports was a massive increase in military imports during 1967-69. The Israeli balance-of-payments category "Government not elsewhere stated (n.e.s.)"* consists of direct government imports -- primarily military goods and services -- which increased from \$159 million in 1966 to \$324 million in 1967, \$366 million in 1968, and an estimated \$410 million for 1969 (see Table 2). During 1967-69, Israel spent more than \$1.1 billion (an average of \$370 million annually) for direct government imports compared with only \$798 million (\$133 million annually) during 1961-66. As a result of the combined growth of civilian and military imports, the total current account deficit increased from \$445 million in 1966 to \$532 million in 1967, \$706 million in 1968, and an estimated \$889 million in 1969.
- 13. Inflows of capital and unilateral transfers fell in 1968 and 1969 from their 1967 high as the impact of the war on private contributors wore off and were not sufficient to finance these deficits. Israel was forced to draw down net foreign exchange reserves by \$98 million in 1968 (see Table 3) and by an estimated \$304 million in 1969. In effect, the buildup of foreign exchange reserves between 1964 and 1967, which resulted from deflationary measures and war-induced capital inflows, was consumed during 1968 and 1969. By December 1969, reserves had fallen to less than \$400 million, or the equivalent of only about two months' imports of goods and services.

Problems for the Future

14. Israel's economic prospects for the 1970s are clouded by major military expenditures the government now expects to make during the early 1970s.** If these sums are actually spent, a

^{*} This category almost certainly includes all goods and services purchased on military account -- not only finished military equipment, but also components for military equipment and imported materials used in military industries.

** Analysis of Israeli military expenditures and evaluation of Israeli military requirements are beyond the scope of this memorandum.

Table 2

Israeli Balance-of-Payments Category
"Government Not Elsewhere Stated"

			Cumulative					
Annual			Million US \$					
Year	Million US \$	Period	Total	Annual Average				
1961 1962 1963 1964 1965 1966 1967 1968 1969 b/ 1970 c/ 1971 d/ 1972 d/ 1973 d/ 1974 d/	93 124 146 129 147 159 324 366 410 A 525 B 555 575 590 615 575	1954-69 1954-60 1961-66 1967-69 1970-74 <u>a</u> /	2,280 372 798 1,110 2,910	142 53 133 370 582				

a. Based on the Bestimate for 1970.

b. Preliminary estimate.

c. Israeli projection. A is the original estimate; while B is the most recent estimate.

d. Israeli projection.

								Million	n US \$
	<u>1961</u>	1962	1963	1964	1965	1966	<u>1967</u>	1968	1969
Bank of Israel	279	419	515	545	643	621	715	663	382
Commercial Bank	85	71	69	76	84	101	120	162	N.A.
Treasury deposits abroad	12	16	31	22	22	8	133	91	N.A.
Gross reserves	376	506	615	643	749	730	968	916	N.A.
Less deposits of foreign residents and foreign banks in Israel	80	100	121	128	138	154	191	237	N.A.
Net reserves	<u>296</u>	406	494	515	<u>611</u>	<u>576</u>	<u>777</u>	<u>679</u>	<u>375</u>
Change from previous year		110	88	21	96	- 35	201	-98	-304

sharp reduction in the growth of civilian imports or substantial foreign assistance will be needed to avoid a balance-of-payments crisis. For the next five years, 1970-74, direct government imports -that is, mainly military imports -- are planned to average \$582 million annually (see Table 4) compared with \$370 million a year during 1967-69 and only \$133 million a year during 1961-66. According to Israeli projections, the annual current account deficit would run about \$1 billion a year through 1974. Such deficits would exceed anticipated capital and unilateral inflows by amounts ranging from \$105 million in 1970 to a high of \$250 million in 1973 and totaling more than \$900 million over the period 1970-74. Judging from current trends and the recently announced 1970-71 Israeli budget, which indicates continued expansionary economic policies and also revises earlier military spending plans upward, the balance-of-payments deficits in 1970 could considerably exceed \$125 millic.

- 15. The Israeli projections probably understate the potential balance-of-payments problems if the projected military expenditures are in fact incurred. Their current account estimates appear reasonable, but those for capital and unilateral inflows appear optimistic.
- 16. The Israeli forecast for imports of goods and services appears to be based on an annual GNP growth rate of about 8%. Historical relationships between Israeli non-military imports and GNP growth indicate that an 8% annual expansion in GNP would require non-military imports of goods and services to grow more than 9% a year for a 1970-74 total of \$11.3 billion.* The Israelis project virtually the same import total (\$11.5 billion); however, the pattern of growth is somewhat different, the rate of import growth being higher in the early part than in the latter part of the period.
- 17. An 8% growth rate seems feasible, given adequate foreign exchange receipts. The average GNP growth rate since the early 1950s has been

^{*} Non-military imports refers to all imports of goods and services other than "Government n.e.s." See the Appendix for a description of the regression analysis used.

Table 4 Israeli Balance-of-Payments Projections

									illion US	5
		197	₀ <u>a</u> /	1971	1972	1973	1974	1970-74 b/	1970-74 C	_
		A	В							
	Current account	-975	-1,105	-1,025	-1,050	-1,075	-1,025	-5,150	-5,280	
1	Imports of goods and services	-2,475	-2,455	-2,675	-2,875	-3,100	-3,275	14,400	-14,380	SE
12 -	Non-military imports Government n.e.s.	-1,950 -525	-1,900 -555	-2,100 -575	-2,285 -590	-2,485 -615	-2,700 -575	-11,520 -2,880	-11,470 -2,910	SECRET
	Exports of goods and services	1,500	1,350	1,650	1,825	2,025	2,250	9,250	9,100	T
	Long-term and medium-term capital	850	1,000	875	875	825	800	4,225	4,375	
	Net unilateral transfers Net repayable capital	520 330	595 405	525 300	515 360	510 315	490 310	2,560 1,665	2,635 1,740	
	Overall deficit	-125	-105	-150	-175	-250	-225	-925	-905	

a. The A estimate for 1970 was part of the five-year balance-of-payments projections nade by the Israeli in the fall of 1969 while the B estimate reflects those projections incorporated in the recently proposed budget for 1970-71.

b. Using the A intimate for 1970.

c. Using the B estimate for 1970.

about 10%. It is unlikely, however, that either the labor force or the stock of productive capital will increase as fast in the next five years as in the 1950s and the early 1960s. Immigration -a major source of new labor -- has slowed, and, with military expenditures up sharply, investment probably will be a smaller share of GNP. In 1969 the share of investment in GNP was 25%; the 1955-65 average was nearly 31%. While the Israeli economy grew by 13% in 1968 and 12% in 1969, a substantial part of this growth was derived from utilization of unemployed resources. Israeli officials claim that 8% is an optimum growth rate under present conditions, representing a compromise between the goals of high employment, a rising standard of living, limited deficits in the balance of payments, and a low rate of inflation. A somewhat higher growth rate possibly could be attained, but probably at the cost of a significant amount of inflation and a larger balance-of-payments deficit.

Israel's growing potential trade gap is not likely to be reduced much by unexpectedly large increases in exports. The Israeli expectation that exports will grow about 11% a year seems realistic. Although exports of citrus fruit and diamonds, about half of total exports, probably will increase relatively slowly, rapidly rising exports of a host of small manufactured items probably will bring the average up. Growth in the value of citrus fruit exports (15% of total commodity exports) probably will not exceed 8% a year despite larger gains in volume because of anticipated price declines in the European market.* Diamond exports (one-third of total commodity exports) may grow by as much as 10% a year, well below the 17% obtained during most of the 1960s. The reason for the expected decline is that Israel, which in the past was able to increase substantially its share of the world market for medium-sized diamonds, has now

^{*} Israel has concluded an agreement on preferential tariffs with the European Common Market, beginning in 1971, that will reduce tariffs on imports from Israel, which totaled \$86 million in 1968, including \$28 million of industrial products. European tariffs on Israeli citrus products will be reduced by 40%.

captured most of this market and that penetration of markets for larger gems probably will be difficult because the polishing of larger gems requires substantially different equipment and techniques than those available in Israel.

- The projected 11% annual growth of exports clearly assumes profitable conditions for Israeli exporters. This means continuation of the wide variety of export promotion schemes already in being and would require devaluation if domestic inflation becomes excessive. Once domestic profitability is assured, however, the volume of export is little affected by price changes. Export prices of polished diamonds, about one-third of the value of commodity exports, are fixed in dollars by an international cartel. Moreover, the demand for other major Israeli exports, citrus fruits and textiles, probably is not highly responsive to price changes. Israel has concentrated on specialty textiles and clothing, the export of which depends more on highly skilled handiwork and fine design than on price. Israel also has a substantial but small export market in custom manufactures where a willingness to fill small orders to specification is critical. The expansion of such markets probably depends upon changes in demand for specialty items rather than on price. Even if exports expanded more rapidly than is currently anticipated, however, such expansion would provide only partial balanceof-payments relief because a dollar of exports on the average requires half a dollar of imported inputs.
- 20. Israeli estimates of receipts from unilateral transfers during 1970-74 seem less realistic than those of imports and exports. These receipts are projected at a level near the \$521 million attained in 1967. But the 1967 level reflects the strong response of world Jewry to the war emergency and was well above both the annual average of \$337 million during 1961-65 and the \$425 million to \$455 million obtained in 1968 and in 1969. To increase these transfers during 1970-74, the Israelis apparently are relying on world Jewry's ability and willingness to contribute more. In view of the evident Israeli military superiority in the Middle East, tight money conditions in the United States and Western Europe,

and the slowdown in US economic activity, however, it seems questionable that the projected contributions will be forthcoming.

- Israeli estimates of repayable capital inflows also seem optimistic. While such inflows rose substantially in 1967, to \$303 million, they declined sharply in 1968 and 1969. The fall stemmed largely from a decline in the sales of Israeli government bonds, which earn far below market interest rates, and, like outright gifts, depend largely on the psychological impact of the Arab threat toward Israel. On the other hand, net direct foreign investment in Israel, which reflects almost entirely economic motivations, fell from \$71 million in 1966 to \$11 million in 1967 and to \$8 million in 1968. Such investment is unlikely to increase substantially until the current political and military unrest in the Middle East is reduced. Conversely, however, relative peace almost certainly would reduce bond sales substantially.
- 22. Thus if Israel maintains a high rate of economic growth and fulfills its planned military imports, its balance-of-payments gap probably will be greater than projected. For 1970, moreover, Israel has raised its military import plan from \$525 million to \$555 million and raised the projection of the current account deficit by an even greater amount (from \$975 million to \$1.1 billion) because of expected shortfalls in exports. To finance this increased deficit the Israelis hope to further increase their receipts from gifts and bond sales and slightly draw down their reserves (see Table 4).

Policy Options

23. Israel would like to fill the incipient balance-of-payments gap by means of official credits from the United States. If it is unable to do this it has the following options:

- (a) Reduce military imports from planned levels;
- (b) Let foreign exchange reserves run down and tap available sources of short-term banking and commercial credit;
- (c) Hold down civilian imports by slowing the growth of the economy and by other means (austerity).

Which of these options might be used, for how long, and in what combination, depends on many things, including development of the military situation, the extent of US military sales, Soviet military support to the Arabs, and the growth of Israel's own military industries.

- 24. If military imports could be cut substantially the balance-of-payments problem would disappear. For example, if annual government n.e.s. expenditures were limited to the high 1967 level of \$324 million, with other balance-of-payments projections being unchanged, then Israel would have a cumulative balance-of-payments surplus of \$335 million during 1970-74 instead of a deficit of \$925 million. Too little is known about the composition of planned military imports to permit a firm judgment as to how easily they could be cut.
- 25. It is clear that Israel cannot rely on a drawdown of reserves and on short-term banking credits to finance large deficits over several years the reserves are too small and the credits too expensive. This approach could be used, however, to cover deficits that were expected to be temporary, even for a year or perhaps two. There is no doubt that Israel could obtain substantial bank credit and its reserves are still in excess of \$350 million while prospective balance-of-payments deficits are of the order of \$200 million a year. In any event, these funds provide ample flexibility in establishing viable long-term economic and military strategies.
- 26. Israel has a variety of policy tools that could be used to hold down non-military imports,

but could not prevent a reduction in the rate of economic growth because of the economy's heavy dependence on imported raw materials and capital goods. Nearly every commodity and service produced in Israel is dependent upon imports to some degree. In 1968, imports of goods and services amounted to about 45% of GNP.

- The loss in aggregate economic growth involved if non-military imports were held down could be minimized through use of quotas and Imports of finished consumer goods in 1968 exceeded \$110 million, or nearly equivalent to the 1970 balance-of-payments deficit projected by the Israelis. Nearly all of these commodities could be eliminated by quotas or prohibitively high tariffs without directly affecting the economy's productive capacity. Use of these policy tools, however, will be avoided if at all possible because Israel recognizes that they lead to an inefficient allocation of resources and would thus hinder the export orientation that Israel must achieve to become self-sustaining in the long run. During the past decade, Israel has been actively liberalizing its foreign trade. Nearly all quantitative restrictions have been eliminated and tariffs have been reduced substantially.
- 28. If the wage-stability agreements should break down, devaluation will become necessary. As indicated earlier,* it would have little effect on the volume of exports. Moreover, because Israeli labor and plant capacity are nearly fully employed, domestic production would not be able to respond readily to the increased demand for domestic goods that would result from the higher prices of competing imported goods. Thus, to dampen inflation and strengthen the beneficial effects of devaluation on the balance of payments, devaluation would have to be accompanied by deflationary fiscal and monetary policies designed to reduce total domestic demand.
- 29. The potential decline in economic growth that might be associated with curtailment of civilian imports in 1970-74 was calculated on the basis of historical relationships between imports and GNP. On this basis, each 1% cut in the GNP growth rate would save some \$60 million to \$70 million a year

^{*} See paragraph 19.

on the average in civilian imports during 1970-74, or a total of \$300 million to \$350 million over the period. The cumulative payments deficit would be reduced from some \$1.8 billion for an 8% growth in GNP to perhaps \$1 billion with a 6% rate, assuming exports are unaffected. To eliminate foreign exchange deficits entirely, the growth of Israeli GNP would have to be lowered to less than 4% a year (see Table 5 for projected current account deficit).

Table 5

Calculated Israeli Balance-of-Payments Projections for Various GNP Growth Rates a/

				Current	Account	Deficit
GNP Growth Rates	1970	1971	1972	1973	1974	1970-74
		······································	Milli	on US	3	
88	924	1,016	1,082	1,166	1,200	5,388
6%	890	943	963	995	964	4,755
4 %	854	865	837	813	710	4,079
2%	817	788	713	636	480	3,434

a. For derivation, see the Appendix.

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Conclusions

- 30. Israel probably cannot finance both its planned military imports for 1970-74 and the growth of civilian imports required to support rapid growth of GNP without foreign assistance.
- 31. Israel could close the potential balance-of-payments gap either by not increasing military imports from recent levels or by restricting civilian imports to levels that would support a 4% growth of GNP instead of the planned 8%, or by some combination of these.
- 32. Foreign exchange reserves and access to commercial credit give Israel considerable flexibility in establishing viable economic and military strategies and are sufficient to finance expected deficits for a year or perhaps two if necessary.
- 33. In the current year, Israel is planning to continue expansionary economic policies and has revised its military import plan upward. These policies will probably continue at least until Israel knows the US response to its economic and military aid request.

APPENDIX

Non-Military Imports and GNP

To forecast non-military imports of goods and services at various levels of GNF during 1970-74, these imports were divided into two parts: (1) imports c.i.f. (merchandise plus insurance and freight) and (2) all remaining services. A least squares fit of the relationship between imports c.i.f. and GNP was obtained for the years 1954-65 and 1968.* This relationship is described by the equation $M(t) = -45 + 0.2335\overline{GNP}(t)$ [where M(t)represents imports c.i.f. in any of the years under consideration and GNP(t) represents GNP in the same years**]. These results mean that for each \$1 increase in GNP, civilian imports are estimated to increase by \$0.23. The correlation between imports and GNP was high, with an R2 of 0.979.***

The correlation between GNP and other service payments, which include such items as profits repatriated by foreign investors, factor payments abroad, nonmerchandise insurance, and Israeli tourist expenditures abroad, was found to be relatively weak. Other services were projected to grow at a constant annual rate. Utilizing a double log transformation and applying a linear regression,

with respect to time, this function was estimated to be $\log OS(t) = 21.62 + 0.069(t)$ for the 1954-68 period, with an R of 0.975. According to this function, OS increases each year by about 17%.

^{*} The 1966-67 period was excluded by use of a dummy variable because a severe recession occurred in Israel during these two years and the relationship between imports c.i.f. and GNP appeared to be distorted.

^{**} The constant factors in all equations are expressed in million US dollars.

^{***} R² is the square of the correlation coefficient and represents the proportion of the total variance of the dependent variable that is accounted for by the variance of the independent variable.